TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate- Report on Single Family Housing   ITEM NUMBER: 8

ATTACHMENT(S): 1

ACTION: _____   DATE OF MEETING: March 8, 2000

INFORMATION: X   PRESENTER(S): Ms. Gerardo Lietz

EXECUTIVE SUMMARY

One of the 1999/00 objectives for the Investment Branch was to "Create and present a program for single-family residential development concentrating on affordability issues."

Pension Consulting Alliance (PCA) has prepared a research report on the investment merits and potential risks associated with a single family housing investment program that has been provided as Attachment 1. The report is divided into six sections:

1. General Background
2. Urban or Suburban
3. Historical Housing Investment Results
4. Residential Investment Opportunities in California
5. Investment Options
6. Conclusions

This report is the first of two agenda items. The next agenda item (scheduled for June 2000) will identify specific investment alternatives and proposed implementation objectives.

M E M O R A N D U M

DATE: February 16, 2000

TO: California State Teachers' Retirement System

FROM: Pension Consulting Alliance, Inc.

RE: HOUSING INVESTMENT PROGRAMS

CONCLUSIONS:

PCA has researched the investment merits and potential risks associated with a housing investment program both in urban and suburban communities. As a result of our research, it is PCA's opinion that:

- CalSTRS should proceed cautiously with regard to a suburban housing investment strategy due to market conditions and the overall economic climate.
- CalSTRS should consider initiating an urban infill housing investment program in conjunction with its general urban investment program, initially in the West Coast.

SUMMARY OF GENERAL HOUSING INVESTMENT ATTRIBUTES

Table 1

MERITS	RISKS
The West Coast, which is the expected initial target market for a residential investment program, has several unique characteristics that support investment in housing.	Ability to sell inventory is highly sensitive to prevailing home mortgage rates, housing affordability and builder access to cheaper sources of capital.
Demand appears to exceed supply in both urban and suburban markets.	Investment strategies have varying degrees of risk, including project financing for public building companies (i.e., lot option deals).
Home prices continue to outpace inflation.	Payback structure may be significantly longer than other more core-oriented real estate investments.
Attractive expected total returns of 20%.	A downturn in income trends and/or consumer confidence would negatively affect existing home prices and new construction.

SUMMARY OF URBAN HOUSING INVESTMENT ATTRIBUTES

Table 2

MERITS	RISKS
Urban infill markets encompass a large and rapidly growing consumer market; appears to have significant pent up demand, especially for low to moderate housing units.	Potential local joint venture partners often have little or no experience managing third-party capital, particularly institutional capital. Their ability to handle reporting, governance and other important issues is questionable.
Less institutional competition.	Exit strategies may be constrained due to negative perceptions regarding urban locations and smaller deal sizes.
Attractive expected total returns of 20%.	Suitable sites for development can be difficult to find and expensive to assemble.
Cities and states are motivated to reduce sprawl and give incentives to urban developers.	Payback structure may be significantly longer than suburban housing investments due to entitlement process and minimal ability to phase projects.

SUMMARY OF SUBURBAN HOUSING INVESTMENT ATTRIBUTES

Table 3

MERITS	RISKS
Projects are generally large and easy to replicate; can be phased based on economic conditions.	Institutional advisors' expansion into new markets has not always produced returns commensurate with expectations and risks.
Less entitlement issues and community opposition.	Potential backlash due to suburban sprawl controls may increase costs of development.
Attractive expected total returns of 20%.	Due to available capital, greater potential to overbuild and oversupply individual markets.
Risks and returns are better known.	Unclear how CalSTRS can effectively complete against existing capital sources for suburban developments.

The following pages present PCA's research and recommendations in more detail.

I. GENERAL BACKGROUND

The housing sector encompasses single family homes, multi-family units and manufactured homes, in both suburban and urban areas. While this section gives a broad-based synopsis of the overall housing sector, it is important to note that the available statistics are dominated by single family, suburban housing.

HOUSING SECTOR OVERVIEW

The relative attractiveness of the housing sector, like all sectors of real estate, is fundamentally driven by the ratio of new supply to demand for new housing units. As is discussed below, the overall supply/demand ratio for the housing sector appears in balance for the near term making the investment environment relatively attractive. However, the demand side of the equation is unequivocally linked to the overall health of the US economy and prevailing interest rates. As rates increase, demand for new housing units will likely slow.

The fundamental factors affecting the supply side of the equation for housing are:

- Capital availability for builders
- Labor costs
- Materials and construction costs
- Favorable regulatory environment for builders (i.e., building permits, zoning restrictions, etc.)

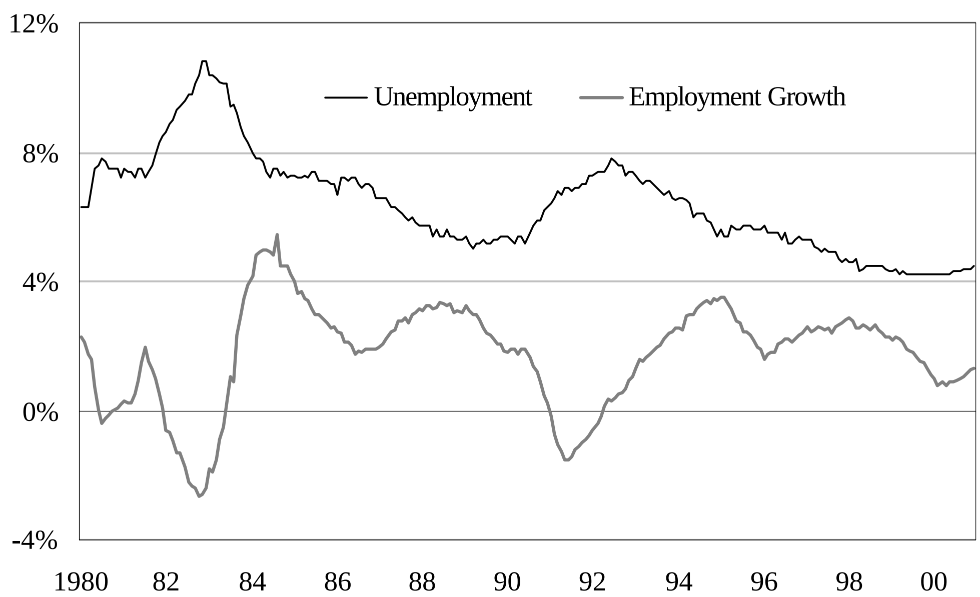
The primary drivers affecting demand for new housing units are:

- Low interest rate environment, making housing more affordable
- Healthy overall economic environment boosting consumer confidence
- New household formations

ECONOMIC CLIMATE

The U.S. economy's sustained growth over the past eight years has brought unprecedented strength to housing production and sales. The unemployment rate hovers at a minimal 4.0%, its lowest since January of 1970.

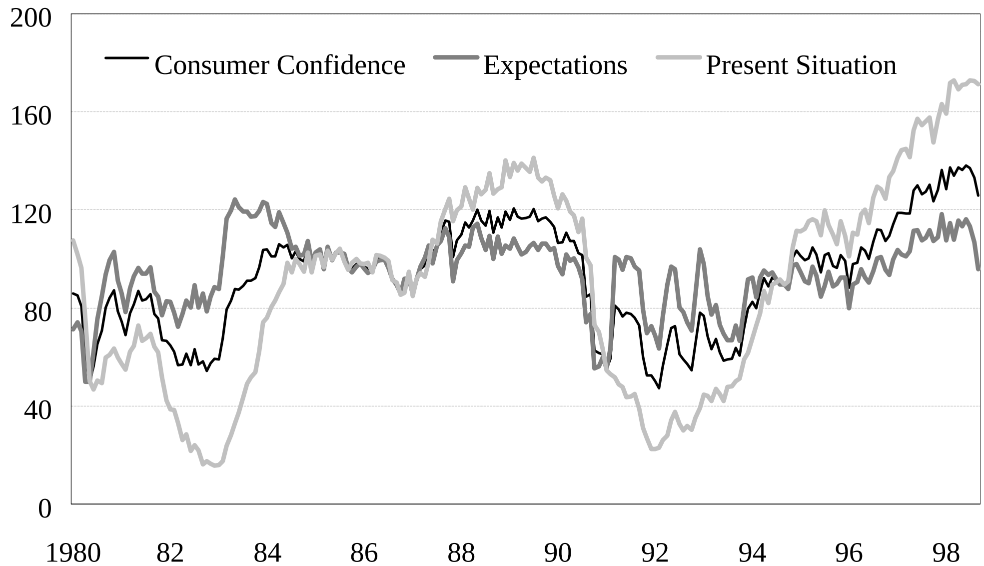
Table 4



Source: Bureau of Labor Statistics, Lend Lease Investment Research

Consumer confidence also set a new record. Despite rising interest rates and higher energy costs, consumers continue to be optimistic in regards to the near-term future of the economy.

Table 5



Source: The Conference Board, Lend Lease Investment Research

Overall, strong employment growth, low mortgage interest rates, and new, more flexible financing options have boosted national homeownership rates to an all-time high. The gains in homeownership are broadly based, with young adults, minority and moderate-income households purchasing homes in record numbers.[1]

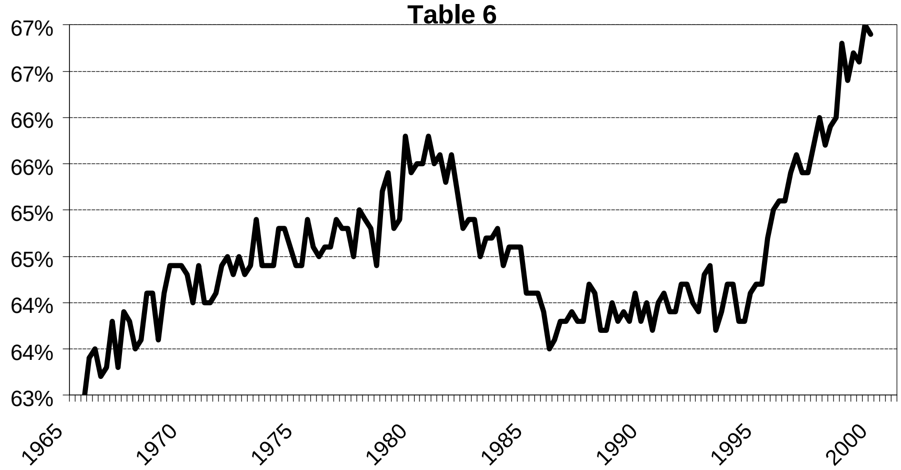
HOUSING DEMAND

Demand is currently running at just below two million units annually, while supply is at a 1.8 million annual pace (total supply includes multi-family and mobile homes as well as single family units).[2] In the long term, housing demand is shaped by fundamental demographic factors, including population growth rate, age distribution of the population, net immigration levels, and household formation rates. In the shorter term, variations in the level of demand are determined by job creation, housing affordability, interest rates, and consumer confidence. Additionally, innovations in mortgage finance (e.g., adjustable rate products, lower down payment requirements, lower transaction costs) are playing an increasing role in expanding homeownership opportunities and reducing market volatility.

As shown in the following chart, a record two-thirds of households in the US now own their own home (twice the rate of home ownership in England, France and Germany). According to the U.S. Census Bureau, home ownership is rising strongly and is near or at record highs across every age and ethnic group, region, and family status.

[1] *The State of the Nation's Housing 1998*; Harvard University Joint Center for Housing Studies.
[2] National Association of HomeBuilders website (www.nahb.com).

US Homeownership Rate
Table 6

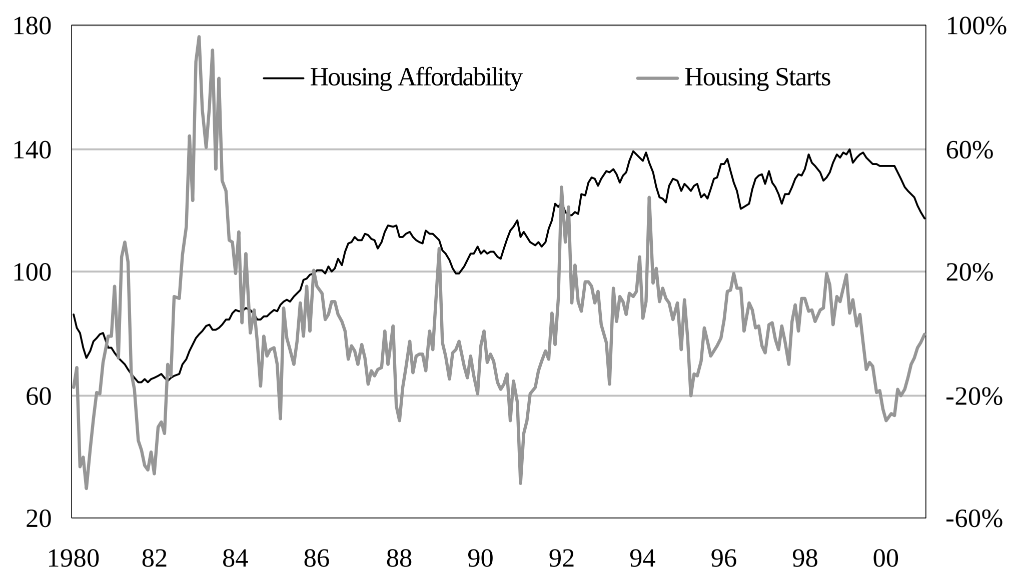


Source: US Census Bureau, PCA

Housing affordability remains very high, thanks to healthy job and personal income gains over the last eight years and the persistence of low mortgage rates. Fixed-rate 30-year mortgages have fallen from an average of almost 10% in 1989 to the 7.5% - 8.25% range in the past few years.

While housing starts have been robust, they have not approached former peaks reached in the early 1980s. However, residential construction ended 1999 much stronger than anticipated, with unseasonably mild weather the driving factor of the late year increase. In 1999, 1.663 million starts were made, compared to 1.617 million in 1998, with single family starts accounting for 80% of the total.

Table 7



Source: Bureau of the Census, NAR, BEA, RFA, Lend Lease Investment Research

LOOKING FORWARD

There is no getting around the direct relationship between the housing market and the overall economy. When job growth slows and consumer confidence begins to slip, housing markets will cool. However, several factors suggest that any downturn in the housing market will be less severe and of shorter duration than those experienced in the past.

Analysts generally agree that the current demand is unsustainable. The strength of the economy and the affordability of housing has raised household formation growth above that which can be supported indefinitely given underlying demographic trends. However, many analysts also allow that the sustainable level of long-term housing demand may actually be quite high.

Regional Financial Associates ("RFA") believes that annual household formation rates will slow to approximately one million, which dictates that long-run sustainable housing demand will level off at about 1.4 million units annually.[3] Looking at essentially the same variables, Harvard University's Joint Center for Housing Studies claims that the total number of U.S. households will grow between 1997 and 2010 at roughly the same rate of growth experienced in the 1990-1997 period (1.56 million units on average per year), which would contribute to housing demand at current levels into the next decade. Harvard argues that although population growth is slowing (the Census Bureau projects that the annual population growth rate of 1.04% experienced in the 1990s will slow to 0.8% between 2000 and 2010), the continuing influx of immigrants and aging of the domestic population should work to keep demand for housing strong.

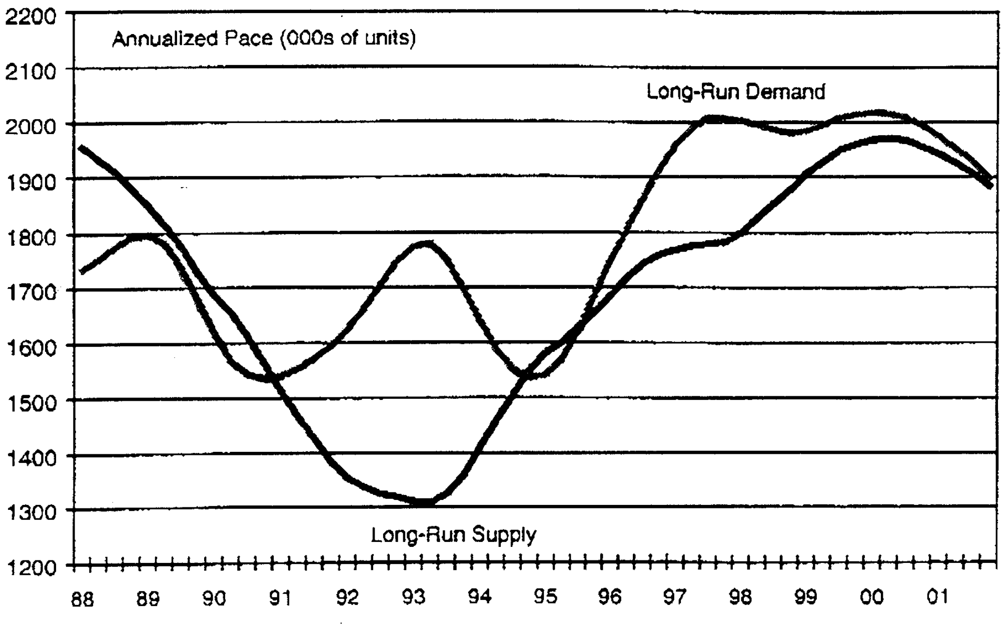
Whatever the exact demand-side figure, several factors on the supply side also support steady housing activity. Lower levels of housing construction and a greater emphasis on conservation have pushed the average age of the housing stock from 23 years in 1985 to 28 years currently.[4] The progressive aging of the housing stock implies additional losses of units and therefore greater replacement activity.

Analysts generally agree that significant pockets of overbuilding do *not* currently exist in the country despite the pickup in housing activity. RFA reports that while most U.S. metros are in balance, California and parts of New England are currently underbuilt and a few small metro areas throughout the Midwest, South and Mountain West are exhibiting signs of overbuilding.[5] House prices have increased an average of 5% over the past several years and should continue to outpace CPI inflation for the foreseeable future. The largest increases for both new and existing home prices have been in the Midwest and West. In these areas the desire for single-family homes is stronger than ever and income growth has countered the effects of the price increase to keep demand high.

Additionally, indications are that builders have not accumulated the excessive land positions or the debt loads they have in previous boom cycles. If these conditions do indeed hold, the chances of a downturn similar to that experienced during the recession in 1990-91 could be significantly reduced.

[3] *The Single-Family Housing Monitor*; December 1999, Regional Financial Associates.
[4] *State of the Nation's Housing 1998*; Harvard University Joint Center for Housing Studies.
[5] *The Single-Family Housing Monitor*, December 1999; Regional Financial Associates.

Housing Demand-Supply Gap is Narrowing
Table 8



Source: RFA

Despite the strong pace of construction in 1999, long-run housing demand still surpasses the existing supply. The gap is narrowing on a national basis, however, and is considerably less than late last year. While the combination of strong consumer confidence, wage appreciation, and rising stock market are positive forces, a decline in both demand and new supply is foreseen.[6]

OTHER GENERAL CONSIDERATIONS

The housing boom is geographically uneven. Historical long-term trends in the regional distribution of housing production are likely to persist, with the South and West continuing to grow faster than the Northeast and Midwest. Successful investment in the homebuilding industry will require discerning selection of projects as well as adequate diversification across geographical areas, builders, product types and price points. Understanding local markets is critical, making the establishment of a national investment program very challenging. It is highly recommended that an initial program in housing be focused in California.

Demographic trends may favor certain segments of the housing industry over others. Specifically, the age and regional distribution of the domestic population favors gains in multi-family and manufactured housing over single family dwellings. However, while the single-family share of new construction may retreat slightly, the absolute number of units built each year will probably remain about the same. Furthermore, the trend toward ever-larger and more expensive homes is likely to keep the value of suburban single-family home construction climbing.

Finally, there are the "crystal ball" questions, many of which underlie the industry's most basic assumptions: Will younger generations make housing investments in patterns similar to those of their parents? Will the recent rise in minority homeownership rates persist in the face of an economic downturn and/or tightening credit conditions? How will future demand be distributed across the single family, multi-family and manufactured housing sectors? How much of the growth in the housing sector

[6] *The Single-Family Housing Monitor*, December 1999; Regional Financial Associates.

will come from urban versus suburban development? If answers to these questions differ substantially from currently held beliefs, projected results will not materialize.

PERSPECTIVES FROM THE STREET

PCA interviewed representatives from five Wall Street investment firms to assess their current perception of the housing sector relative to other property types within the real estate market. It should be noted that the analysts concentrate most of their attention on the public real estate sector, and as a result, most of the following comments pertain to apartment and multifamily product types developed and operated by the larger public developers and REITs.

The following bullet points summarize the representative Wall Street outlook on housing.

- Real estate is coming off of a strong, sustained cycle and transitioning towards a mature stage as the improvement in fundamentals has begun to plateau. Somewhat lower returns are expected to accompany this transition.
- With supply expected to exceed demand for all major property types over the next few years, most firms are mildly bearish on all real estate sectors. Risks to fundamentals on the downside appear greater than those on the upside, particularly in light of weakening supply/demand fundamentals and limited acquisition opportunities.
- Nevertheless, relative to other property types, investment firms remain relatively upbeat on apartment companies because of their “less unattractive” projected oversupply coupled with opportunities to grow through consolidation.
- Demand is expected to remain fairly stable. Slowing job growth will be offset to some degree by a higher propensity to rent (versus buy) as interest rates rise. Other demographic trends are also expected to bolster the renter market.
- On the supply side, the short construction cycles associated with housing projects ensure that any short-term back-up in vacancy will be offset by a slowing supply pipeline; corrections in the apartment supply pipeline occur much more quickly than in other real estate sectors.
- Although apartments face the least significant risk of oversupply of the four major property types, some oversupply during the next five years now seems likely. The absorptions-to-completions ratio is expected to remain below 1.0 through 2003, and projections by F.W. Dodge show prospective apartment supply running about 1.1% higher than prospective demand for the next two-year period. This would result in overall vacancy increasing from 7.1% to 8.0% over this period.
- Nonetheless, most firms view apartments as a ‘safe haven’ in volatile economic times, and the majority are maintaining an overweight position in the less cyclically sensitive apartment and manufactured housing sectors. They expect multi-family housing to fare better than other sectors in the face of interest rate movements and the slowing corporate earnings they anticipate across the economy.
- Particular favor is given to those companies in markets with greater barriers to entry (such as parts of California and the Northeast).
- The most likely trouble spots will be in the South where the new under-construction supply is heavily concentrated.
- Though most firms see limited growth opportunities for real estate companies through asset acquisition, they do see increasing profits arising from the convergence of technology and real estate that permits (i) increasing revenue and (ii) lowering costs. For apartment owners, services like cable and telephone can be purchased wholesale and then resold at a markup to tenants. Additionally, new “resident management systems” can be used to realize efficiencies across all aspects of operations, and on-line listing services are creating dramatic new marketing channels, giving potential tenants information on thousands of properties for sale or lease.

- Analysts note that in funding housing development, profit margins – the excess of projected value over cost – must be watched very carefully and underwriting criteria in general need to be rigorously conservative.

II. URBAN OR SUBURBAN?

The most profound land use change during the last half of this century has been the suburbanization of population and jobs. As a result of this out-migration within America's central cities, population density has declined by 50% since 1950. As of 1990, almost 80% of the nation's population lived in the suburbs and today 80% of new office construction is taking place in the suburbs.

The shift to a postindustrial, service-oriented economy has had a complex effect on patterns of urbanization. Rapid technological change has opened new vistas of creativity and flexibility, thereby giving people and businesses more freedom of movement. As businesses have followed the middle income population to the suburbs, the cities have been left with higher concentrations of immigrants, minorities and elderly, with a resultant greater proportion of poverty. In addition, central cities are plagued by two predominant issues that make them difficult places in which to live and that deter investment in housing: (1) urban school systems are perceived as ineffective and unsafe, and (2) urban neighborhoods are perceived to have excessive levels of crime, drug-related activity, gangs and unemployment.

There are several trends that run counter to the *perceived* decline in many urban areas. Changes in demographics and a rapidly diversifying population are changing the nature of what constitutes a "household". The traditional nuclear family now represents less than 15% of all households in the US. Singles and couples without children comprise over 56% of all households and are the two fastest growing demographic groups. This demographic shift, along with the rediscovery of urban amenities, increasing frustration with the lack of character and diversity in the suburbs, increasing traffic congestion and reduced urban crime rates, has spurred the demand for both owned and rental infill housing. In the near term, though, the shift of traditional family units to the suburbs is likely to continue until there is a perceived improvement in the urban school systems.

From a developer's perspective, the economics currently remain overwhelmingly in favor of suburban sprawl, and may explain why the supply-driven housing production system typically ignores "new" urban markets. There is a consensus amongst builders and developers that, compared to greenfield development in the suburbs, urban infill development is more costly, takes more time for land assemblage and approvals, and often entails strong community opposition. The focus on suburban development has been fueled by the ability of larger homebuilders to develop on a significantly greater scale than in urban centers. Since profit margins in the homebuilding industry are "thin" (in the range of 10% to 15% per unit), the developer profits accrue as much from volume as they do from per unit margin.

Additionally, large homebuilders can apply a more "cookie cutter" approach in securing the necessary zoning and building permits in the suburbs versus urban environments. Each urban project tends to have unique regulatory issues that require greater time to resolve than their suburban counterparts. Again, the larger developers are motivated to gravitate to the suburbs where the perception is that it is easier to develop.

Large capital sources such as banks, pension funds, Wall Street, etc. find it easier to analyze an investment area if it is of such a size that they can commit or earn significant capital to/from the opportunity. It is perhaps not surprising that the Wall Street analysts focus on the largest public homebuilders and developers at the expense of smaller firms operating in urban infill environments.

Similarly, pension fund investors have followed their advisors to the suburbs when capital investments of some scale (providing greater diversification and volume of profits) could be made. The vast preponderance of pension fund housing investments have been made in suburban communities in large part because the advisor can oversee a 200-unit development as easily as they can oversee a 10-unit development in the city. (See Section III for investment results.)

Urban housing developments also often require the development/redevelopment of other property types, especially retail, in order to be successful. Many of the traditional homebuilders have little or no experience in developing mixed-use facilities. Again, their incentive is to develop in those areas catering to their specific expertise.

PCA believes there is an opportunity for pension fund investors in urban infill housing investments, but the implementation of such a program may involve a different series of issues than those associated with suburban housing developments. The fact that larger capital sources have bypassed this area in and of itself creates some opportunity. While capital sources for urban housing development and redevelopment exist at both the federal and state level, they are not of the size of the traditional institutional investment community. Urban investment opportunities are likely to be competitive, but there is not upwards pricing pressure associated with the presence of large amounts of capital to invest.

The potential difficulties associated with urban housing developments include: (1) the individual projects may be smaller, requiring a greater number of relationships to achieve scale; (2) administration of such a program consequently may be more difficult; (3) the local developers may lack the development experience of the larger homebuilders who have built on a significantly greater scale; and (4) the risk management of individual urban projects differs from suburban developments.

On this last point, in an urban environment it may be necessary to develop vertically (i.e., condominiums or rental housing) which necessitates that the project must be completed in its entirety instead of in phases. In the suburbs, developers can wait to build incremental units until completed units have been absorbed. Also, urban housing developments will likely include attached housing. Suburban developers have shunned building homes with common walls as these projects have higher insurance costs and greater potential risks of litigation than do detached housing projects.

There are a number of other ancillary benefits associated with urban housing developments. Infill development offers an opportunity to revitalize older declining neighborhoods, has the potential to take advantage of and enhance existing public transit alternatives, and will promote additional investment and economic activity by creating demand for more goods and services. The use of infill parcels for residential development can minimize the consumption of agricultural land and other open space at the urban fringe and reduce long commutes, automobile use and fuel consumption by creating housing close to the central city and to public transit. Nonetheless, cheaper, unencumbered land in the suburbs will continue to be the focus of most development activity unless public agencies create incentives and favorable entitlement/permit processes that will encourage development in urban areas.

PCA’s research included interviews with developers and lenders specializing in both urban and suburban housing. The results of those conversations lead PCA to the following conclusions:

- There is an abundance of capital available for suburban housing investment and most institutional investors are participating in this market segment due to availability and scale.
- Urban infill housing is highly desirable from both low and high income consumers, but is more difficult to produce in scale due to land assemblage and entitlement processes, and the need for common wall developments.
- Large, mixed-use projects effect the positive changes to urban areas needed to create appropriate demographic shifts.
- Inner city housing development is best achieved as part of a mixed-use concept – homeowners require convenient amenities/services which in turn need consumers to be viable.
- Some component of urban housing developments may include rental housing, not just build-to-sell developments to qualify for certain federal and state tax credits or other enhancements.
- Urban infill investment requires flexibility and patience, but can result in attractive returns.

III. HISTORICAL HOUSING INVESTMENT RESULTS

As previously discussed, most statistics and track records deal with suburban housing. As shown in Table 9, returns financing suburban housing have generally been very attractive. These returns are a function of a number of factors that converged over the past five years:

- the overall economic environment has been very favorable to housing;
- low interest rates led to record housing affordability;
- as Table 8 illustrates, there was a pent up demand due to the lack of construction from 1988 through 1993.

These factors greatly facilitated developers' ability to sell inventory at a rapid pace. The question is whether this return pattern can continue. PCA believes the returns nationally for suburban housing developments will moderate due to the fact that the pre-existing supply/demand imbalance has been eliminated (See Table 8). Further, in addition to pension fund capital in the form of separate accounts, commingled housing funds and opportunity funds, the banks have returned as a competitive source of financing developers. These factors may put downward pressure on returns.

In the return data shown in Table 9, the programs are all institutional in nature, and predominantly comprised of equity investments, except for the Housing Investment Trust ("HIT"), in suburban housing development. Run by the AFL-CIO, HIT uses a combination of direct equity, straight debt and participating debt to invest in housing projects. The program is development-oriented, often providing construction financing that evolves into an equity position in the completed project. The program also dedicates a portion of its investments to an Urban Strategies Initiative, which generally encompasses urban economic projects in underserved communities that rely on public sector resources for risk mitigation and/or development subsidies. Approximately 15% of HIT's $2.2 billion in assets fall under the Urban Strategies Initiative at this time.[7]

[7] Jim Campbell, Chief Investment Officer, AFL-CIO Housing Investment and Building Investment Trust.

Housing Returns
Table 9

Manager/Fund	$000	Number of Projects	Total Units	Total Return	IRR (3)
Westbrook	66.3	4	N/A	N/A	23.9% (6)
Olympus II	75.1	6	1,998	N/A	27.0%
Colony Investors II	105.2	6	N/A	N/A	25.0%
Hearthstone Olympia (1)	51.0	48	6,813	0.3% (4)	18.5%
Hearthstone Multi-State	134.0	98	12,265	N/A	4.0%
Morgan Stanley (MSREF III)	72.7	N/A	N/A	N/A	22.7%
Hearthstone Housing Partners (1)	21.0 (2)	83	8,826	25.1% (5)	20.1%
Institutional Housing Partners (1)	157.0 (2)	64	6,872	29.1% (5)	20.4%
Prudential Home Building Investors(1)	58.9 (2)	41	4,702	24.0% (5)	16.7%
Residential Real Estate Partners(1)	28.0 (2)	30	2,994	20.0% (5)	20.9%
Wells Fargo Realty Advisors(1)	36.5 (2)	32	2,321	37.0% (5)	23.7%
HIT (mortgage program)	N/A	N/A	N/A	9.0% (7)	N/A

All returns are gross of fees.

Notes:
(1) Institutional separate account
(2) Outstanding capital balance.
(3) Blended actual and projected IRRs for realized and unrealized investments made over the past five years.
(4) Time-weighted total return since inception of program as of September 30, 1999.
(5) Time-weighted total return since inception of program as of June 30, 1999.
(6) Individual project IRRs were 23.9%, 38.0%, 52.4% and 122.5%.
(7) Time-weighted total return since inception of program as of March 31, 1985.

PCA believes an investor in urban housing developments should be able to achieve similar returns. Urban investment programs may include potential opportunities to increase returns through participation in below-market financing and/or government-sponsored projects (e.g., tax credits, credit enhancement programs, reduced or abated planning and permit fees, etc.). The two primary forms of federal financial assistance are IRS tax credits and HUD block grants. IRS Section 42 Low Income Housing Tax Credits ("LIHTC") have been the de facto federal rental housing production program since its creation in the Tax Reform Act of 1986. They are awarded through state agencies for rental units only based on affordability levels set by the state. These credits generally represent 30-40% of project cost and require a minimum holding period of 15 years. A review of more than 2,500 LIHTC projects performed by the Fannie Mae Foundation revealed that these projects serve low-income households but remain out of reach for very poor renters. Serving the lower-income households requires rental subsidies in addition to the LIHTC capital subsidy.

Federal tax credits are saleable and are thus a common way for banks, insurance companies and corporations to make equity investments in urban projects. While there is some risk associated with these investments, an efficient market has evolved for the credits, which currently yield around 12%. Historically, these credits had yields of 20% or more, but over time, considerably more of each tax-credit dollar has ended up in the projects, and returns to equity investors have dropped significantly, perhaps reflecting an increased understanding of project risks.[8] The California Tax Credit Allocation Committee awards approximately $450 million per year in federal and state tax credits to assist in the construction and rehabilitation of affordable rental housing.[9]

HUD Community Development Block Grants are the other primary form of federal financial assistance for urban housing developments. Block grants supply funds to cities and urban counties to support the development of viable urban communities. These programs must be used to meet at least one of three objectives: benefit low and moderate-income people; eliminate or prevent slums and blight; or, meet other urgent community development needs (e.g., health care clinics, day care centers). Generally, a specified percentage of the development, single family or multifamily, must be available to low-income (defined as households not exceeding 50% of the median income of the area) and moderate-income (defined as less than 80% of median income) people.

In addition, there is a host of other federal programs that are designed to enhance credit, mitigate risk, or otherwise subsidize urban development projects, including grants, loans, mortgage insurance, operating subsidies and other affordable financing vehicles. State-sponsored programs offer additional tax-exempt bond financing, low-interest financing, working capital loans, training, technical support and other forms of assistance to support the purchase, construction and/or rehabilitation of low-to-moderate income housing and improvement projects in distressed neighborhoods.

While government programs can potentially enhance returns on urban housing development, the primary returns will be supported by the severe supply/demand imbalance that exists for urban housing, especially at the low to moderate income levels. Projects targeting this segment in well-located urban areas with access to overall amenities such as grocery and drug stores should do well. Additionally, the lack of large capital sources, in contrast to the situation in the suburbs, also suggest that returns should be competitive.

The case for urban housing investments appears compelling, assuming the implementation issues of scale and oversight can be managed. However, for the reasons previously discussed, CalSTRS' potential participation in urban housing investments makes more sense in the context of larger scale mixed-use projects. Housing is necessary to support the retail/commercial projects and vice versa.

[8] *The Low-Income Housing Tax Credit: An Analysis of the First Ten Years*: Jean L. Cummings and Denise DiPasquale. Fannie Mae Foundation 1999.
[9] *Smart Investments*, June 1999; Philip Angelides

IV. RESIDENTIAL INVESTMENT OPPORTUNITIES IN CALIFORNIA

The State of California has several key attributes for housing investment programs. First and foremost are the state's demographic trends. California is expected to experience above national average population and job growth over the next ten years, with 6 million new residents, 3 million new jobs, and 2 million new households. Roughly 70% of this growth will come from minority populations in urban areas around the cities of Los Angeles, San Francisco and San Diego.

This growth has several important consequences for urban areas. A growing population places increasing pressure on land, environment, and quality of life, and will require higher density developments in infill locations. Additionally, the population growth combined with the robust state economy has resulted in an increasing imbalance between job growth and housing additions. In the late 1980s, California developers produced one new housing unit for every 1.6 new jobs in the state.[10] Over the last two years, California added 870,600 jobs and only 160,100 net occupied housing units – a ratio of 5.4 new jobs to each new household. The demand for housing in California is indisputable.

RFA has measured the supply/demand balance of housing throughout the U.S. in terms of the number of months of excess supply, which is similar in concept to an inventory-to-sales ratio.[11] They have determined that nationally there is a two-month excess demand over the next year. In the ranking of the 25 tightest metro area markets in terms of excess demand, California markets represent eleven of those designations, with months of supply ranging from 8.7 in Los Angeles to 3.4 in Santa Rosa. (See Table 10 below.) In addition, the historical trends show that these areas have exhibited comparable excess demand over the past ten years. Clearly, even with increased residential construction, developers in California are having difficulty meeting housing demand.

Table 10

METRO AREA	SUPPLY (months)
New York, NY	9.8
Los Angeles-Long Beach, CA	**8.3**
San Francisco, CA	**7.5**
Bergen-Passaic, NJ	7.4
Beaumont-Port Arthur, TX	5.7
Oakland, CA	**5.5**
Modesto, CA	**5.0**
Springfield, MA	4.8
Santa Barbara-Santa Maria-Lompoc, CA	**4.7**
Miami, FL	4.5
Orange County, CA	4.3
Newark, NJ	4.2
Nassau-Suffolk, NY	4.0
Trenton, NJ	3.9
San Jose, CA	**3.9**
San Diego, CA	**3.8**
Davenport-Moline-Rock Island, IA	3.7
Huntsville, AL	3.7
Riverside-San Bernardino, CA	**3.4**
Santa Rosa, CA	**3.4**
Vallejo-Fairfield-Napa, CA	**3.3**
Boston, MA	3.2
West Palm Beach-Boca Raton, FL	3.2
Peoria-Pekin, IL	3.1
Spokane, WA	3.1

[10] *MultiFamily Trends*, November/December 1999.
[11] *The Single-Family Housing Monitor*, December 1999, Regional Financial Associates.

In terms of demand for low to moderate income families for affordable housing, the supply/demand imbalance appear even greater. California ranks 47th of the 50 states in terms of the percentage of home ownership. The low ranking is a function of the high cost of housing. The state includes 11 of the top 25 least affordable metropolitan areas in the country. Much of the pent-up demand for housing is in these urban metropolitan areas.

Several of California's local city and county governments have assumed a very proactive stance with respect to public/private partnerships aimed toward urban investment.[12] San Jose, San Francisco and San Diego have all reduced their bureaucratic processes and have demonstrated a cooperative spirit in facilitating the consolidation, entitlement and development of inner city sites. Importantly, having benefited from increased tax revenues as a result of the healthy economy, these cities have money and land sites to contribute to these projects.

[12] "Beyond Sprawl: New Patterns of Growth to Fit the New California," California Resources Agency in partnership with Bank of America, Greenbelt Alliance and the Low Income Housing Fund, 1998.

V. INVESTMENT OPTIONS

CalSTRS' options to pursue housing opportunities are:

- Commingled Funds
- Separate Accounts with Advisors Supervising Local Developers (CalPERS model)
- Direct Joint Ventures

In terms of commingled funds, CalSTRS' options are limited. There are no national or California-specific programs targeting housing for either urban or suburban housing. Whether such products will be developed by the time CalSTRS enters an implementation phase is unknown.

There have been investment programs which include components of urban housing, but their focus is primarily debt oriented. They are briefly summarized below:

California Community Mortgage Fund ("CCMF"): Lend Lease sponsored the CCMF in 1991 and is presently sponsoring a follow-on fund. These programs invest in mortgage loans on multi-family units that provide affordable housing units and commercial income properties located in underserved neighborhoods. CCMF has generated superior risk-adjusted returns, albeit on a relatively short-term basis, compared to the Giliberto/Levy Mortgage Index. As of September 30, 1999, CCMF reported total one-year return of 5.7% compared to 1.0% for the Giliberto/Levy Mortgage Index, on a loss-adjusted basis.

Housing Investment Trust ("HIT"): Run by the AFL-CIO, HIT uses a combination of direct equity, straight debt and participating debt to invest in housing projects. The program is development-oriented, often providing construction financing that evolves into an equity position in the completed project. The program also dedicates a portion of its investments to an Urban Strategies Initiative, which generally encompasses urban economic projects in underserved communities that rely on public sector resources for risk mitigation and/or development subsidies. Approximately 15% of HIT's $2.2 billion in assets fall under the Urban Strategies Initiative at this time.

Capri Capital: Capri is a pension fund investment manager specializing in first-mortgage financing and mezzanine capital, and a multi-family lender on behalf of Fannie Mae and the FHA – the firm originates loans that are generally securitized in exchange for assuming 20% of the credit risk of everything they originate. They currently have $4.0 billion of assets under management, roughly 30% of which are affordable housing and commercial properties in urban areas. They have a zero default rate and earn better than market returns (with commercial projects generating somewhat higher returns than housing projects). Capri focuses on the Northern and Southern California, Chicago and Washington D.C. markets.

Separate accounts remain an option for CalSTRS, the structure of which will have to be reviewed during the implementation phase. Whether traditional advisors are the optimal firms to supervise the activities of local housing partners will have to be analyzed during the implementation phase. This approach is essentially the model followed by CalPERS in their housing program.

CalSTRS could pursue a program of direct joint ventures with local developers on a project by project basis. This would require the identification of potential partners and underwriting the transactions they submit to CalSTRS or giving them discretion to proceed with the project. We should note that many of the local developers are likely to be firms with little or no experience in managing third party, institutional capital. Under these circumstances it would be difficult to grant investment discretion to these firms. Further, the Staff has limited experience in underwriting urban investments and their potential role in the due diligence process is unclear. Lastly, monitoring direct investments and firms with limited experience managing institutional capital would take a disproportionate amount of Staff time.

VI. CONCLUSION

PCA has researched the investment merits and potential risks associated with a housing investment program both in urban and suburban communities. As a result of our research, it is PCA's opinion that:

- CalSTRS should proceed cautiously with regard to a suburban housing investment strategy due to market conditions and the overall economic climate.

- CalSTRS consider initiating an urban infill housing investment program in conjunction with a general urban investment program, initially in the West Coast.

APPENDIX

Contacts who contributed to this report:

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